

# Protecting Foreign Investments and Arbitration

Political risk is unavoidable in any international investment transaction. Governments often reshuffle the rules of the game

for legitimate and not so legitimate reasons, and this can negatively affect both the prospects for and the value of an investment. The degree of political risk is inversely proportional to the strength of the government institutions and the rule of law in a jurisdiction: the weaker the institutions and rule of law, the greater the political risk. The good news is that foreign investors can assess and manage political risk. Bilateral investment treaties (BITs) have become essential tools in managing foreign investment political risks because they grant substantial rights to foreign investors, provide safeguards to investments against foreign governments, and typically enable foreign investors to remove investment disputes from the jurisdiction of local courts. The following examples illustrate this concept.

1. A U.S. company built facilities to manufacture automotive and dry cell batteries and import and resell consumer goods and foodstuffs in the Democratic Republic of the Congo (then known as the Republic of Zaire). During a civil war, the plant was occupied and destroyed by military forces. The company did not have a contractual relationship with the Zaire government. Did the U.S. company lose everything? The answer is no. The company was able to recover a very significant portion of its investment after filing the dispute with an international arbitration forum and obtaining a favorable award under the United States-

Zaire Bilateral Investment Treaty. Treaty Between the United States of America and the Republic of Zaire Concerning the Reciprocal Encouragement and Protection of Investment, Aug. 3, 1984.

2. A U.S. investor became a majority shareholder in an Argentine company and invested over \$400 million in a concession agreement to operate water and sewage services in a province. The contract provided that the courts of that province would resolve all disputes related to the concession agreement. A bitter and highly political dispute arose regarding tariffs shortly after the contract was signed. Did the local court system offer the only possibility to the investor to obtain redress? The answer is no. The U.S. investor obtained a large award after filing with an international arbitration forum under the United States-Argentina Bilateral Investment Treaty. Treaty Between the United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment, Nov. 14, 1991.

3. Another U.S. company acquired rights to develop a very valuable oil field in Venezuela in the 1990s. Shortly afterward, a new government came to power and planned to force the company to renegotiate the original deal under the threat of nationalization. The United States and Venezuela had not agreed to a BIT. Was the investor bereft of recourse? The answer, again, is no. The U.S. investor restructured its investments in Venezuela before the measures were passed and transferred the relevant assets to a subsidiary in the Netherlands. After the measures were implemented, the U.S. investor filed a claim under the Venezuela-Kingdom of the Netherlands

Bilateral Investment Treaty. Agreement on Encouragement and Reciprocal Protection of Investments Between the Kingdom of the Netherlands and the Republic of Venezuela, Oct. 22, 2002.

4. Yet another U.S. company wants to invest in China today in a highly regulated area of the economy. The U.S. company is concerned that after it invests the Chinese government might adopt measures that could negatively affect the returns on the investment. The United States and China do not have a BIT. Could the U.S. company initiate arbitration in an international arbitration forum against China if the Chinese government expropriates the investment? The answer is yes, if the U.S. investor structures his investment in China taking into account the BITs between China and *other* countries.

These examples are not simply hypothetical. They describe real situations illustrating how U.S. companies have used BITs to cope with existing and potential risks when investing abroad. The first case described is *American Manufacturing & Trading, Inc. v. Democratic Republic of the Congo*, ICSID Case No. ARB/93/1, which was decided in 1997 by an arbitration tribunal constituted under the rules of the International Centre for the Settlement of Investment Disputes (ICSID), discussed in greater detail below. The second example corresponds to *Azurix Corp. v. Argentine Republic*, ICSID Case No. ARB/01/12, a 2006 case that was also decided by an ICSID tribunal. The third example resembles a current, pending case, *Exxon and Venezuela, Mobil Corporation and Others v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB/07/27. The fourth example illustrates one of the many questions that we receive from clients investing abroad.



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## BITmania

In 1959, a simple suggestion was made by a German business association to the German government that Germany should enter into treaties with other countries to provide specific protections to foreign investors to shield the investors from governmental interference. The suggestion became the root of one of the most significant legal phenomena of contemporary, international, economic law.

The first recorded BIT was signed between Germany and Pakistan in 1959. Switzerland followed, entering into a BIT with the Philippines that same year. Several other European countries, such as Belgium, France, the United Kingdom, Italy, and the Netherlands continued this trend during the 1960s and 1970s. The United States began its BIT program only in 1981, but since then it has signed 47 BITs, as well as 20 free trade agreements containing chapters that operate as BITs, such as Chapter 11 of the North American Free Trade Agreement.

As of the early 1990s, less than 500 BITs were in place. In addition, very few individuals understood their relevance because the first claim under a BIT, *Asian Agricultural Products Limited v. Democratic Socialist Republic of Sri Lanka*, ICSID Case No. ARB/87/3, was filed only in 1987. By the end of the millennium, more than 2,000 BITs were in force, but even then only a handful of disputes were publicly known. It took the Argentine crisis of 2001 to bring BITs truly to the forefront of international law and political-risk investment management. The measures adopted by the government of Argentina to cope with the crisis were challenged in over 40 international arbitrations by foreign investors invoking the respective, applicable BITs. Now, over 300 cases have been filed under BITs during the last decade, many involving claims worth billions of dollars, evidence that awareness of BITs has increased.

## Anatomy of a BIT

A BIT typically consist of three parts: (1) provisions defining a BIT's scope; (2) substantive protections and treatment standards; and (3) dispute settlement provisions.

## A BIT's Scope

The scope of a typical BIT is defined by pro-

visions that describe (1) the persons and entities that can invoke its terms, (2) the assets that are covered, and (3) the temporal framework for the operation of the treaty.

## Who Can Invoke a BIT

Most BITs afford protections to all foreign nationals investing in a foreign state

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in accordance with the laws of the contracting parties. Although sometimes certain restrictions apply to persons who have dual nationality, in practice, only a handful of cases have involved individual investors, since international investments are generally made by companies.

The types of companies that a BIT protects will vary, depending on the treaty. In most cases a BIT covers companies incorporated under the laws of the contracting parties. In many cases, a BIT also protects companies controlled by foreign nationals or companies from a contracting country, even if the companies are constituted under the laws of the host country or of a third country.

Some BITs have specific provisions designed to prevent opportunistic "forum shopping," which may happen when an investor establishes an investment vehicle in a country for the exclusive purpose of benefiting from that country's BIT. Such a BIT provision may require the company "seat" to be located in the home state of the investment, or require the company to have substantial business activities in the relevant jurisdiction.

## Investments Covered by a BIT

BITs define the term "investment" very broadly. Almost any conceivable type of right or asset invested in the territory of the host country is included in the definitions of-

ten found in a BIT. Numerous cases have involved disputes about concession contracts, bonds, private contracts, and shareholding interests, as well as other type of assets.

## A BIT's Temporal Framework

To take effect in a contracting state, a BIT usually requires ratification or other similar steps after the contracting states sign the treaty. (For example, although Brazil has signed over a dozen BITs, it has not yet ratified any of them.) It is also important to note that, while a BIT typically covers *investments* made both before and after a BIT takes effect, and a BIT's protections generally extend beyond its expiration for a certain time period, *measures* that the host government takes before a BIT takes effect generally *are not* covered.

## Substantive Protections

The degree of protection provided to foreign investors varies among BITs and depends on the specific terms of each treaty. However, BITs generally provide the following standard protections.

## Expropriation Redress

Most BITs obligate host states to provide adequate compensation to foreign investors in the event of expropriation. Generally, expropriation is broadly construed to encompass both the outright taking of an asset (direct expropriation), as well as "measures tantamount to expropriation" (indirect expropriation). Indirect expropriation may involve a taking through governmental conduct that, in the aggregate, deprives a foreign investor of its property rights, control, or the value of its investment, even when the beneficial title remains with the investor.

## Fair and Equitable Treatment Standard

The fair and equitable treatment standard is the basic treatment standard that the host state must afford a foreign investor. Today, fair and equitable treatment is the standard most frequently invoked by foreign investors, and most successful claims have been resolved based on this standard.

There are basically two approaches to the fair and equitable treatment standard. Under the first approach, host governmental measures must be unreasonable and

arbitrary to be prohibited. The fact that a measure is simply illegal may not be sufficient. The second approach is more flexible, and basically requires the host government to behave in a manner consistent with the legitimate expectations of the foreign investor. The host government is required to maintain the stability of the legal and business environment in place at the time of an investment, conditions that the foreign investor would have relied on when making an investment decision.

#### **Currency-related Protections**

Almost all BITs specify that a foreign investor can transfer funds related to its investment from the host state without delay, and many include provisions that govern converting investment-related funds to foreign currency. For example, all BITs concluded by the United States include provisions guaranteeing U.S. investors the right to transfer, without delay, all moneys related to their investments into and out of host countries, using a market exchange rate.

#### **Most-favored-nation Treatment and National Treatment Clauses**

Although the scope depends on the exact wording, the general goal of a most-favored-nation clause is to ensure that the host country provides a foreign investor with treatment that is at least as favorable as the treatment provided to other foreign investors, and the goal of a national treatment clause is to ensure that the host country provides a foreign investor with treatment that is at least as favorable as the treatment provided to its own nationals.

The application of most-favored-nation clauses in particular has been very controversial in interpreting dispute settlement provisions of BITs. Some foreign investors have argued that a most-favored-nation clause permits an investor to resort to the dispute resolution provisions in other treaties, rather than relying on the investor's country's BIT with the host state.

National treatment clauses aim to prevent discrimination, be it legal discrimination (through host nation laws explicitly benefiting locals and excluding a foreign investor covered by a BIT from the same benefits) or informal, *de facto* discrimination.

#### **Umbrella Clauses**

Some BITs and other international treaties offer an additional layer of protection to investors by providing that if a host state breaches a contractual or legal obligation to a foreign investor, the host nation automatically has violated the treaty. The scope of such "umbrella clauses" in BITs is highly

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controversial, and the case law is inconsistent. Nevertheless, many United States BITs contain umbrella clauses that U.S. investors have successfully invoked in various disputes.

#### **Full Protection and Security Standard**

This standard is generally understood to require a host government to protect a foreign investment's or investor's physical integrity against actions of the host state's agents, such as the military and local police, and, in some cases, nongovernmental persons, for instance, civilians, during civil unrest.

#### **Pre-Establishment Rights**

Recent United States BITs and free trade agreements provide market-access rights, in addition to substantive protections. This feature is rarely present in other BITs. It allows U.S. investors to invest in sectors of the economy of a host country that might be restricted to other foreign investors.

#### **Access to International Arbitration**

Most recent BITs provide investors with the ability to enforce BIT protections through international arbitration. Under a BIT, an investor generally has total control over its

claim and, typically, is not required to exhaust local remedies. This is a revolutionary development, as the international remedies historically available to protect foreign investors typically required an aggrieved investor to exhaust all available remedies in the host state's domestic courts before permitting the foreign national's government to intercede in the investor's favor.

Most BITs, however, do require that investors wait for a certain period of time, a "cooling off" period of usually three or six months, before commencing arbitration. And although BITs generally do not require foreign investors to exhaust all local remedies, they typically will contain some reference to the interaction between an international claim and local courts. For example, depending on the particular BIT, an investor (1) may be required to resort to the local courts for a certain period of time before it is allowed to file an international arbitration claim; (2) may have to choose whether to pursue a claim in the local courts or before the ICSID, with the choice of one option precluding the other; (3) may file a claim in the local courts and then commence an international arbitration after waiving its right to further access the local courts, except for preliminary and declaratory actions; or (4) may be allowed to directly pursue international arbitration with no restriction other than complying with the cooling off period. Obviously, paying close attention to these types of provisions from the outset of a dispute is essential to avoid forfeiting the possibility of resorting to international arbitration.

Most BITs also provide alternatives regarding the type of arbitration that a foreign investor can pursue under the treaty. In most cases, an investor can choose between an arbitration under the ICSID Convention or an ad hoc arbitration under the rules of the United Nations Commission on International Trade Law (UNCITRAL). Some BITs also refer to other arbitration centers, such as the Arbitration Institute of the Stockholm Chamber of Commerce and the International Court of Arbitration of the International Chamber of Commerce.

#### **The ICSID Convention**

In the late 1950s, the World Bank, concerned with fostering the inflow of capital

into developing countries, began promoting the creation of a neutral and impartial forum for the resolution of disputes arising from cross-border investments. These efforts led to the creation of the International Centre for Settlement of Investment Disputes (ICSID), which operates under the authority of a treaty, the ICSID Convention. Convention on the Settlement of Disputes between States and Nationals of Other States, March 18, 1965 (also called the "Washington Convention"). The ICSID Convention provides a unique set of arrangements to promote neutrality and facilitate award enforcement in disputes between foreign investors and host states. To date, 145 countries have ratified the ICSID Convention.

In recent years, the ICSID has become a very significant international forum for resolving foreign investment disputes, due, in part, to two features that many investors find attractive. First, an ICSID award is only subject to limited review performed by a special committee appointed by the ICSID. In other international arbitrations, a national court (often that of the host state) will review the award. Second, ICSID Convention-contracting states have agreed to treat and execute an ICSID award as a final decision from their own courts; thus, achieving recognition and enforcement of an ICSID award does not require a special procedure. Of course, as with any enforcement action against a foreign government, domestic and international rules regarding sovereign immunity may protect certain types of assets of a foreign country from execution. And as with any dispute involving a sovereign nation, automatic or unchallenged enforcement of an ICSID award (or any other arbitration award, for that matter) is not guaranteed, and certain countries on the losing end of an arbitra-

tion award have occasionally flouted treaty obligations in resisting enforcement. At least in the case of an ICSID award, however, noncompliance by a contracting state enables the other contracting state to start proceedings against the defaulting state before the International Court of Justice. *See* ICSID Convention, Art. 64.

ICSID arbitration requires compliance with specific jurisdictional requirements, specified in the ICSID Convention. *See* ICSID Convention, Art. 25. The most relevant are that (1) a contracting state and a national of another contracting state must have a legal dispute; (2) the dispute must arise directly from a foreign investment in the relevant contracting state; and (3) the two contracting states must provide written consent to arbitrate the dispute under the ICSID Convention. As to this last requirement, the simple fact that a foreigner has invested in an ICSID Convention-contracting state does not establish the required written consent. However, two states agreeing to a BIT often will include a provision constituting such "written consent" in the BIT. Investment contracts will also sometimes include a consent provision, and a few countries provide foreign investors with access to international arbitration in their domestic legislation.

### **Managing Political Risk Through BIT Strategic Planning**

Foreign investors can manage political risk in various ways. Traditionally, foreign investors will obtain political risk insurance and negotiate both procedural and substantive protections when contracting with foreign governments. Other ad hoc approaches that may help reduce political risk when investing include having a local partner, or involving a multilateral

lending institution in a project. Relying on a BIT clearly complements such strategies for coping with political risk. What makes BITs unique, however, is that they are available at no cost and with no strings attached, other than fulfilling their nationality requirements. (*See* "Who Can Invoke a BIT," above.)

BIT investment-risk-management strategic planning is relatively simple. It requires (1) verifying the existence of a BIT that is in force between an investor's state of nationality and the host state; (2) considering the availability of other BITs with third countries and assessing whether channeling an investment through entities that are covered by those BITs is possible, efficient, and convenient; and (3) carefully reviewing the express wording of available BITs to understand the scope of their protections, and to determine whether the BITs allow investors to resort to arbitration under the ICSID Convention or otherwise.

Importantly, while international tribunals generally have been lenient regarding compliance with the nationality requirements in BITs, BIT investment-risk-management strategic planning has been attacked successfully, particularly where an arbitration tribunal might perceive the structuring or restructuring of the investment as fraudulent or demonstrating bad faith.

BITs can prove to be extraordinary tools to manage political risk, and the growing number of cases filed under BITs shows that foreign investors have clearly started to recognize their benefits. Of course, BITs will be useful tools only to the extent that they are "used" and not "abused." Thus, planning ahead and considering carefully the path that an international investment may take can be as important to the investment's protection as the BIT itself. 